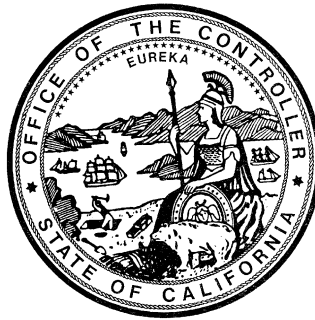


CALIFORNIA LOTTERY

Audit Report

SCRATCHER TICKET DISTRIBUTION AUDIT

July 1, 2009, through June 30, 2011



JOHN CHIANG
California State Controller

January 2013



JOHN CHIANG
California State Controller

January 14, 2013

California Lottery Commission
600 North Tenth Street
Sacramento, CA 95811

Dear Commissioners:

The State Controller's Office audited the California Lottery's (Lottery) Scratchers game ticket distribution process for the period of July 1, 2009, through June 30, 2011.

Our audit disclosed that the Lottery does not have formal written procedures for handling duplicate Scratchers ticket packs received from the ticket vendor, and that the warehouse managers are not consistently filling out the Stock Received Reports for some of the Scratchers ticket game pack deliveries as required by State Administrative Manual section 10832.

If you have any questions, please call Andrew Finlayson, Chief, State Agency Audits Bureau, at (916) 324-6310.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/vb

cc: Nathaniel Kirtman III, Commissioner
California Lottery Commission
John Smolin, Commissioner
California Lottery Commission
Phil Tagami, Commissioner
California Lottery Commission
Robert T. O'Neill, Director
California Lottery
Nicholas Buchen, Deputy Director, Finance
California Lottery
Roberto Zavala, Chief Internal Auditor
California Lottery
Connie M. Perez, Commissioner
California Lottery Commission
Gregory Ahern, Commissioner
California Lottery Commission

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Audit Report

Summary

Our audit of the California Lottery's (Lottery) Scratcher ticket game distribution process for the period of July 1, 2009, through June 30, 2011, disclosed that the Lottery does not have written formal procedures for handling duplicate Scratcher ticket packs received from a game vendor. In addition, the warehouse managers are not consistently filling out the Stock Received Reports for Scratcher ticket pack deliveries.

Background

By authority of the California Constitution, Government Code section 12410 states, "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment." In addition, Government Code section 12411 stipulates that "... the Controller shall suggest plans for the improvement and management of revenues."

Proposition 37, the California State Lottery Act of 1984, amended the California Constitution to authorize the establishment of a statewide lottery, to create the California Lottery Commission, and to give the commission broad powers to oversee the operation of a statewide lottery.

Pursuant to Government Code section 8880.46.6, the SCO may conduct other special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the California Lottery Commission.

The Lottery's Sales and Marketing Division manages the Scratcher ticket game distribution. The Sales and Marketing Division includes the Scratchers Inventory Management Center and two distribution centers (northern and southern) that provide services to more than 21,000 retailers statewide.

The Sales and Marketing Division, Scratchers Inventory Management Center (SIMC) utilizes the Instant Product System (IPS) Scratchers E-Z ship program to distribute "auto ship" and maintenance ticket orders to retailers. SIMC staff provide bi-weekly Scratcher ticket game inventory management services to the Lottery's retailers. SIMC staff also use IPS to assess existing Scratcher ticket game inventory, generate Scratcher ticket game orders, and resolve retailer problems regarding delivery of tickets, accounting information, and contractor problems.

The Sales and Marketing Division's two distribution centers are responsible for organizing and maintaining proper distribution, issuance, and destruction of Lottery Scratcher tickets. Lottery's management over the Scratcher ticket game inventory provides assurance that:

- The Scratcher ticket game inventory is accurate;
- Assets are safeguarded; and
- All statutory restrictions are observed.

On July 21, 2011, the Lottery's Security/Law Enforcement Division (SLED) led an investigation about a group of Scratcher game tickets packs that were not cashing through the terminals. Further investigation revealed that the vendor included one set of duplicate Scratcher game ticket packs in the shipment to the Northern Distribution Center and another set of duplicate Scratcher game ticket packs to the Southern Distribution Center. These duplicate Scratcher game ticket packs were included in the daily shipments to the retailers. SLED investigators ordered that these duplicate Scratcher ticket games be pulled to prevent further distribution to the public.

Objectives, Scope, and Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. We did not audit the Lottery's financial statements. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The purpose of the audit is to determine whether the Lottery's controls over the Scratcher ticket game distribution are adequate. The audit period was July 1, 2009, through June 30, 2011.

The objectives of the audit were to:

1. Identify the internal controls over the Scratcher ticket distribution process;
2. Determine if those internal controls are in place to safeguard the Scratcher ticket inventory for distribution, maintenance, and destruction of Scratcher tickets during the audit period; and
3. Determine if the Lottery is in compliance with laws, rules, regulations, and policies related to Scratcher ticket distribution.

The audit included, but was not limited to, the following audit procedures:

1. Reviewing the California Lottery Act, California Statutes, and other applicable policies and procedures related to Scratcher ticket game distribution;

2. Reviewing work performed by any external audit organization, by the Lottery Internal Audits Office, or by any other Lottery units;
3. Performing tests to determine whether control objectives are being properly achieved; and
4. Determining whether the unsold Scratcher tickets were completely destroyed.

Conclusion

Our audit disclosed that the Lottery did not have formal written procedures for warehouse personnel to follow for handling duplicate tickets. In addition, southern warehouse personnel did not consistently fill out the Stock Received Reports (Std. 106) for their Scratcher game ticket pack deliveries, as required by State Administrative Manual, section 10832. Written procedures are necessary for the warehouse personnel to follow in order to prevent the distribution of duplicate Scratcher ticket packs to the retailers.

**Views of
Responsible
Official**

We issued a draft report to the Lottery dated October 9, 2012. Robert T. O'Neill, Director, responded by the attached letter dated November 20, 2012. Mr. O'Neill agreed with the findings and recommendations.

Restricted Use

This report is intended for the information and use of the California Lottery, the California Lottery Commission, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of the final report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

January 14, 2013

Findings and Recommendations

**FINDING 1—
The Lottery lacks
written procedures
for handling
duplicate Scratcher
ticket packs**

Our audit disclosed that the Lottery did not have written procedures to handle duplicate Scratcher game ticket packs that were received from the Scratcher game ticket vendor. On July 21, 2011, the Lottery Security/Law Enforcement Division discovered that a duplicate Scratcher game ticket pack was being sold by one retailer in northern California. That Scratcher game ticket pack originally was issued and confirmed to a retailer in southern California. The duplicate Scratcher game ticket pack was shipped from the Scratcher game ticket vendor. The duplicate set of Scratcher game ticket packs went to the Northern California Distribution Center, while the original Scratcher game ticket pack went to the Southern California Distribution Center.

The Northern California Distribution Center personnel then included the duplicate Scratcher game ticket pack with an existing order. On July 21, 2011, the Lottery was made aware that this duplicate pack was sold at a northern California retailer because the duplicate Scratcher game tickets could not be cashed or redeemed through the retailer's terminal. The Lottery's Security/Law Enforcement Division took action and pulled the remaining Scratcher game tickets with the same pack number on July 25, 2011.

On January 3, 2012, we requested written procedures for handling duplicate Scratcher gaming tickets from the northern and southern distribution center managers. The northern and southern distribution center managers informed us that they did not have written procedures to handle duplicate Scratcher ticket packs. On February 21, 2012, we received the written procedures for handling duplicate Scratcher game tickets from the Lottery's Sales and Marketing Division, seven months after the incident occurred.

The lack of updated written procedures for handling duplicate Scratcher ticket packs at the Distribution Centers may result in two packs of duplicate tickets being shipped to two different retailers, and then being claimed by two different players. This type of situation would impact the Lottery's integrity and compromise players' assurances of the Scratcher ticket games.

State Administrative Manual (SAM) section 20050 states that experience has indicated that the existence of one or more of the following danger signals is usually indicative of a poorly maintained or vulnerable control system. These symptoms may apply to the organization as a whole or to individual units or activities. Entity managers should identify and make necessary corrections when warned by any of the following danger signals:

- Policy and procedural or operational manuals are either not currently maintained or are nonexistent.

- No procedures are established to ensure that controls in all areas of operation are evaluated on a reasonable and timely basis.

The Internal Control – Integrated Framework report from the Committee of Sponsoring Organizations of the Treadway Commission, a leader in establishing a common internal control model, defines one of the components of internal control – Control Activities – as “policies and procedures that necessary actions are taken to minimize risks to achievement of the entity’s objectives.”

Recommendation

We recommend that the Lottery update its warehouse procedures to ensure that all policies and procedures are specific to its operations, and are comprehensive enough to allow personnel to perform each step of its operations. In addition, Lottery management should regularly review and update the written procedures in case there are any changes to the Lottery’s warehouse policies.

Lottery’s Response

The Lottery agrees with this finding to ensure that all policies and procedures are current and accurate. As noted in the draft Scratcher Ticket Distribution Audit report, the Lottery has in place written procedures for handling duplicate Scratcher ticket packs at both Northern and Southern Distribution Centers.

As part of the organization change, the two Scratcher Ticket Distribution Centers have moved to the Operations Division. Currently, policies and procedures for the Scratcher Distribution Centers are under review and will be updated as appropriate.

SCO’s Comment

The Lottery concurs with the finding and recommendation.

**FINDING 2—
The Southern
Distribution Center
doesn't consistently
complete the Stock
Received Report
(STD. 106) for
Scratcher game ticket
receivables**

Our audit disclosed that the Southern Distribution Center does not consistently complete the Stock Received Report (Std. 106) for its Scratcher game ticket pack receivables as required by SAM section 10832 and its own written procedures for receiving trucks with new game tickets. We tested 14 Scratcher games received during our audit period, July 1, 2009, through June 30, 2011. Ten out of 14 (71.43%) of those Scratcher games received, lacked the required Stock Received Report. However, the Northern Distribution Center consistently completed a Stock Received report for every Scratcher ticket game shipment received for items tested.

Without a completed Stock Received Report, the Lottery is not assured that the condition, quantity, and actual date of Scratcher ticket game packs received were not compromised. The Stock Received Report serves as a receipt for the Lottery as to quantity of Scratcher ticket game packs received by the Lottery's distribution centers, date received, and condition of ticket game packs upon arrival. The Lottery's Accounting Department uses the Stock Received Report as a way to verify what was actually delivered to the warehouse before making payment.

SAM section 10832 states:

The storekeeper will prepare a Receipt for Direct Deliveries, Std. Form 115A as a carbon copy of the Stock Receipt Report, Std. Form 106, for direct delivered items. The Stock Received Report number will be shown the Receipt for Direct Deliveries. The unit head who ordered the goods will check the quantity received, on the Receipt for Direct Deliveries, and send it to the accounting office. The accounting office will compare the signed Receipt for Direct Deliveries with the Stock Received Report. The Receipts for Direct Deliveries may be filed by allotment for management purposes after they have been compared to the Stock Received Reports.

The Lottery's warehouse procedures for Receiving Trucks with New Game Tickets (12k) states:

Complete the Stock Received Report (SRR) and put original in the file for this Scratcher ticket game. Make extra copies of the SRR report so that each game received on that SRR will have its own paper, plus make sure that you highlight the game number on each paperwork by the game so that it will be filed under that game. Give all of the shipping paperwork to the Warehouse Supervisor or Manager so that they can perform the next procedure.

Recommendation

We recommend that all existing written procedures for the handling of Scratcher game tickets received should be enforced and used by both northern and southern warehouses. The filling out of the Stock Received Report is required by SAM section 10832 and aids in reconciling and confirming direct deliveries by the Accounting Office.

Lottery's Response

The Lottery agrees with this finding and has revised its practices at the Southern Distribution Center including consistently completing the Stock Receivable Report for Scratcher game ticket receivables. The Lottery recognizes the importance of the Stock Received Reports in assuring the quantity and quality of Scratcher Tickets received and will utilize them in authorizing payment to Scratcher Ticket vendors. However, for one vendor the Lottery uses a different method for confirming delivery and payment of Scratcher Tickets received.

Per contract terms, the Lottery pays one vendor based on Scratcher Tickets sold, not when received. The Lottery verifies and approves payment of Scratcher Tickets sold by using its internal net settlement reports which identify Scratcher Tickets sold. For this vendor the Lottery will still complete a Stock Received Report; however, the Stock Received Report will not be used in the payment process because the vendor is not paid for unsold Scratchers Tickets, even though they were received at its Distribution Centers.

SCO's Comment

The Lottery concurs with the finding and recommendation.

**Attachment—
California Lottery's
Response to Draft Report**

700 North Tenth Street
Sacramento, CA 95811
calottery.com



November 20, 2012

Mr. Jeffrey V. Brownfield, Chief
Division of Audits
State Controller's Office
P.O. Box 942850
Sacramento, CA 94250-5874

Re: Lottery Scratcher Ticket Distribution Audit

Dear Mr. Brownfield:

Thank you for the opportunity to respond to your draft report on the California Lottery's (Lottery) Scratcher Ticket Distribution Audit for the period July 1, 2009 through June 30, 2011. As stated in the draft audit report dated October 9, 2012, the specific objectives of the audit were to determine if the Lottery has controls in place to ensure that:

1. Identify the internal controls over the Scratcher ticket distribution process;
2. Determine if those internal controls are in place to safeguard the Scratcher ticket inventory for distribution, maintenance, and destruction of Scratcher tickets during the audit period; and
3. Determine if the Lottery is in compliance with laws, rules, regulations, and policies related to Scratcher ticket distribution.

Although no significant internal control issues were identified, the audit identified opportunities to improve the current written warehouse procedures for handling duplicate Scratcher ticket packs and ensure all established written procedures are enforced including the completion of the Stock Received Report (STD. 106) at the Southern Distribution Center. The Lottery has implemented changes to address these issues. The Lottery offers the following response to your findings and recommendations:

Finding 1

The Lottery lacks written procedures for handling duplicate Scratcher ticket packs.

Recommendation

We recommend that the Lottery update its warehouse procedures to ensure that all policies and procedures are specific to its operations, and are comprehensive enough to allow personnel to perform each step of its operations. In addition, Lottery management should regularly review and update the written procedures in case there are any changes to the Lottery's warehouse policies.

Response

The Lottery agrees with this finding to ensure that all policies and procedures are current and accurate. As noted in the draft Scratchers Ticket Distribution Audit report, the Lottery has in place written procedures for handling duplicate Scratchers ticket packs at both Northern and Southern Distribution Centers.

As part of the organizational change, the two Scratchers Ticket Distribution Centers have moved to the Operations Division. Currently, policies and procedures for the Scratchers Distribution Centers are under review and will be updated as appropriate.

Finding 2

The Southern Distribution Center doesn't consistently complete the Stock Received Report (STD. 106) for Scratchers game ticket receivables.

Recommendation

We recommend that all existing written procedures for the handling of Scratchers game tickets received should be enforced and used by both northern and southern warehouses. The filling out of the Stock Received Report is required by SAM section 10832 and aids in reconciling and confirming direct deliveries by the Accounting Office.

Response

The Lottery agrees with the finding and has revised its practices at the Southern Distribution Center including consistently completing the Stock Received Report for Scratchers game ticket receivables. The Lottery recognizes the importance of the Stock Received Reports in assuring the quantity and quality of Scratchers Tickets received and will utilize them in authorizing payment to Scratchers Ticket vendors. However, for one vendor the Lottery uses a different method for confirming delivery and payment of Scratchers Tickets received.

Per contract terms, the Lottery pays one vendor based on Scratchers Tickets sold, not when received. The Lottery verifies and approves payment of Scratchers Tickets sold by using its internal net settlement reports which identify Scratchers Tickets sold. For this vendor the Lottery will still complete a Stock Received Report; however, the Stock Received Report will not be used in the payment process because the vendor is not paid for unsold Scratchers Tickets, even though they were received at its Distribution Centers.

If you have any additional questions, please contact the Audit Chief, Roberto Zavala at (916) 822-8358.

Sincerely,


Robert T. O'Neill
Director

**State Controller's Office
Division of Audits
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Sacramento, CA 94250-5874**

<http://www.sco.ca.gov>